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SUBJECT: PERU 2007 INVESTMENT CLIMATE STATEMENT (PART 2/2)

REF: 06 STATE 178303

The following is Part 2 of Embassy Lima's submission of the 2007 Investment Climate Statement for Peru.

Transparency of the Regulatory System

The transparency and independence of regulatory processes have become central issues for foreign investors in Peru. Many of the central government entities with which foreign firms must deal -- including the entities that maintain the company registry and supervise securities and exchanges (CONASEV), handle privatization and investment issues (ProInversion), and handle competition policy and intellectual property matters (INDECOPI) -- have procedures that are relatively transparent and predictable. Banks, insurance companies and private pension funds are regulated primarily by the Superintendency of Banking and Insurance (SBS), which is charged with determining the qualifications of potential market entrants and regulating firms once they have begun operations. SBS regulations are also seen as being transparent.

When the GOP privatized state-owned monopolies in the areas of telecommunications, electrical generation and distribution, and the hydrocarbons sector in the late 1990s, the GOP established regulatory institutions to oversee the newly private sectors. Delays and lack of predictability in the rulings of these institutions, including OSIPTEL (telecom) and OSINERG (energy), have at times in the past been notable impediments to doing business in Peru.

In December 2005, OSIPTEL published a new law that lowers Peru's high mobile termination rates to levels comparable to international rates over a 3-year period. Several U.S. companies have encountered problems with the energy sector

regulator (OSINERG) over its hesitancy to provide clear regulation for the energy sector. Some regulatory agencies have in the past been subject to politically motivated government intervention in their technical operations.

U.S. firms have complained that SUNAT's aggressive behaior and interpretation of law are often contrary to the spirit of the law and intent of government policies, complicating normal business operations. The remuneration of SUNAT employees is determined, in part, by the theoretical tax liability they uncover in audits.

Businesses point out that SUNAT's retroactive reinterpretation of regulations and laws, its levying of disproportionate fines, and initiation of full company audits when companies request a refund or legal revaluation of assets for depreciation purposes, create additional investment and trade barriers. In one case, a U.S. firm requested an improper drawback of USD 1,345, only to face SUNAT fines of USD 645,000. Although the case was resolved, new legislation was needed to correct the problem. In instances involving airline fuels, certain minerals, and other products, SUNAT declared that these goods sold abroad, which under Peruvian government policy are exempted from taxes, were not considered exports and were therefore subject to VAT. Two recent laws were necessary to correct this practice for airline fuels and services. SUNAT often does not follow standard international practice in the way it taxes new activities. To correct these problems, the independent tax tribunals act to check any abuses by SUNAT. In 2004, the GOP established a tax ombudsman who must approve SUNAT's request to appeal adverse tax tribunal decisions. In the past two years, the tax ombudsman has acted in several cases to end unwarranted litigation of disputed assessments. In 2005, a U.S. company won long-standing tax cases against SUNAT as a result of these improvements.

A 2006 World Bank study found that Peru has significantly lowered the average amount of days it takes to start a business from 98 (2005 study) to 72. Various procedures -- such as obtaining buildng licenses or certificates of occupancy -- require many steps. Municipal authorities issue most licenses and requirements vary widely by locality. As a result, information on necessary procedures is often difficult to obtain. Business people often complain of excessive red tape; one major foreign investor found that starting project construction and a business required several hundred permits, many of which the responsible government entities were unaware they had to issue. Other investors argue that local governments and municipalities, which are seeking new revenue sources, sometimes withhold licenses or create regulations, thus hindering the ability to do business or making it costlier. Even though import tariffs are substantially lower than previously (the simple average tariff is 8.3 percent ad valorem plus surcharges as of January 2007; the trade-weighted average using 2005 import figures is 5.6 percent), import duties, together with the 19 percent value added tax on goods, high social security tax rates, and certain labor laws, increase investment costs significantly and hinder the efficient mobilization and allocation of investment capital. Businesses can apply for VAT reimbursement.

Efficient Capital Markets and Portfolio Investment
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Credit is allocated on market terms and the banking industry in Peru is generally considered to be competitive in offering services to business customers. Private pension funds have competed in recent years with financial companies for bonds issued by companies, as demand for securities greatly exceeds supply. Foreign investors can obtain credit on the local market and several of them have done so in the last few years as terms were more competitive than those of the usual international centers. The private sector has access to a variety of credit instruments. From January through early December 2006,

firms placed USD 1.55 billion on the local bond market (compared with USD 1.47 billion in CY 2005), which has been propelled in recent years by demand for investment instruments by private pension fund companies. By October 2006, pension funds managed a total of USD 13.4 billion, a 43 percent surge over the October 2005 level (USD 9.4 billion), thus creating a huge and growing appetite for financial instruments by pension funds. The low 12 percent cap placed by the Central Bank on what the pension funds can invest abroad provides local bond issuers (including the government) and loan seekers with a captive capital market.

All firms listed on the Lima Stock Exchange (Bolsa de Valores de Lima) or the Public Registry of Securities must be vetted by CONASEV, the National Commission for the Supervision of Companies, Securities and Exchanges, which maintains the Public Registry of Securities and Stock Brokers. CONASEV is the Peruvian government entity charged with the study, promotion, and regulation of the securities and commodities markets, the control of market participants, the maintenance of a transparent and orderly market, the setting of accounting standards and the publication of financial information about covered companies. As part of CONASEV's goal to promote market transparency, to prevent monopolies, and to prevent fraud, issuers of stock are required to inform CONASEV and the relevant stock exchange or body in charge of supervising the centralized trading mechanism, of events that affect or might affect the stock, the company, or any public offerings. Although trading on insider information is technically a crime, no one has been charged and punished under the law.

Total assets of the commercial banks were USD 24.1 billion at the end of October 2006, 16 percQt above the same period of 2005. The banking system is considered generally sound, as it weathered rather well a severe El Nino and global financial turmoil in 1997-98. Sound supervision, combined with competition, led to a significant consolidation in the sector, which still continues. Consequently, 12 commercial banks comprise the system, of which 3 banks account for just over three-fourths of loans and almost four-fifths of deposits. Banks have revamped operations, increased capitalization, and reduced costs in recent years. As of November 2006, foreigners had significant shares in nine banks, of which they were majority owners of four commercial banks (including two of the country's largest). Under the SBS's conservative criteria, 1.9 percent of total loans were assessed as non-performing as of October 2006, down from a high of 11 percent in early 2001. The system also has 3 specialized institutions ("financieras") and 39 thriving micro-lenders and savings banks.

Larger private firms often use "cross-shareholding" and "stable shareholder" arrangements to restrict investment by outsiders -- not necessarily foreigners -- in their firms. As close families or associates generally control ownership of Peruvian corporations, hostile takeovers are practically non-existent. Peruvian law and regulations do not authorize or encourage private firms to adopt articles of incorporation or association to limit or restrict foreign participation; nor are there any private or public sector efforts to restrict foreign participation in industry standards-setting organizations.

In 2006, SBS approved a license for the first U.S. company to provide retail credit services, thus increasing competition for incumbent banks and Chilean finance companies.

Foreign direct investment registered with ProInversion as of the end of 2005 was USD 14.3 billion, compared with USD 13.9 billion a year earlier. Foreign portfolio investment (dematerialized holdings of securities only) totaled USD 9.6 billion in October 2006, up from USD 7.7 billion at the end of December 2005.

Political Violence

Although political violence against investors is not a common practice, the mining and petroleum communities witnessed an increase in protests, some violent, in 2005. These leveled off in 2006. These protests caused several foreign companies to significantly delay or abandon plans to establish operations. Protests against the mining industry occurred for various reasons. Although environmental concerns were often the cited pretext, in many cases protestors were seeking social infrastructure investments not provided by the government. Often times, well-organized groups, such as the Ronderos (local self-defense groups established during the Shining Path terrorist attacks) or NGOs, exaggerated a local community's concerns, bringing in protestors from outside the local community to foment protests against the companies. In at least two incidents in 2005 and 2006, the local mayor and other local authorities led strikes against two large foreign mining companies in an effort to secure additional funds or development promises from the companies. During 2005 and 2006, there were road blockages and acts of vandalism by groups protesting mining operations, coca growers protesting the Government's eradication policies, and farmers seeking increased government tariff protections and financial support. Some indigenous communities in an oil production area used river and road blockages as a way to press for their demands on a long-standing pollution case. A common thread for many protests is the lack of government provision of basic services such as health and education. Another complaint that can underlie what appear to be environmental protests is a lack of access by local communities to the various "canons," the funds set aside by the government out of the taxes or royalties paid by the oil, gas and mining firms for local community development. In some mining areas, firms and local leaders have alleged that narcotraffickers are fomenting protests as a way to keep prying eyes away from their activities.

When significant conflicts developed in the first few months of the Garcia Administration, cabinet ministers and often the Prime Minister became personally involved in successfully resolving the protests. The government established a commission in late 2006 to prevent and resolve social conflicts in the extractive industries. In addition, various NGOs have become involved in conflict resolution activities. At the same time, the National Society of Mining and Petroleum (SNMPE), as well as the government, have become involved in assisting local communities to access the extractive industry canons as a way to both stimulate local development and head off social conflicts. It is reasonable to posit that many of these efforts should pay off to reduce social conflicts for investors in 2007.

Political violence remains a concern in the coca-growing regions. The Shining Path (Sendero Luminoso) terrorist organization has become increasingly aggressive and involved in narcotrafficking in these areas. The Shining Path killed eight civilians and five police officers in 2006, and were responsible for 92 serious terrorist incidents that year. In December 2005, the Shining Path killed 13 police officers in several ambushes in coca-going areas of Huanuco and Apurimac. President Garcia continues to reauthorize 60-day states of emergency in parts of Peru's five departments where the Shining Path operates, suspending some civil liberties and giving the armed forces authority to maintain public order.

There is little government presence in the remote coca-growing zones of the Monzon and the Apurimac-Ene River valleys. The U.S. Embassy in Lima restricts visits by official personnel to these areas because of the threat of violence by narcotics traffickers and remaining columns of the Shining Path. Information about insecure areas and recommended personal security practices can be found at

http://www.ds-osac.org/.

Corruption

It is illegal in Peru for a public official or employee to accept any type of outside remuneration for the performance of his or her official duties. Peru has ratified both the UN Convention Against Corruption and the Organization of American States' Inter-American Convention Against Corruption. Peru is not a member of the Organization of Economic Cooperation and Development, and has not signed the OECD Convention on Combating Bribery.

Peru is one of four nations worldwide participating as a pilot country in the G8 anti-corruption and transparency initiative. The U.S., other G8 partners and NGOs helped the Peruvian government develop an action plan that includes activities in six areas: a) citizen information/internet connectivity; b) improving central government fiscal transparency; c) development of GOP procurement systems; d) improving regional/local government transparency and management; e) improvement of transparency of extractive industry revenues; and f) development of asset forfeiture systems and legislation.

The G8 initiative has already shown some positive results. A hemisphere-wide state procurement organization Q the Inter-American Organization of Government Procurement Institutions Q was created under the leadership of Peru's State Procurement Council (CONSUCODE). As of January 2007, eight countries are in the process of adopting the network agreement, prior to its signature (Bolivia, Colombia, Ecuador, Honduras, Mexico, Paraguay, Peru and Paraguay). Also, efforts are underway to provide Internet connections to approximately 90 municipal governments located in areas most affected by terrorism and poverty. The rural connectivity project will allow these governments access to national systems, part of the GOP's E-government initiatives, aimed at creating greater transparency and citizen access to public information.

U.S. firms have reported only a small number of problems directly resulting from corruption, usually in government procurement processes and in the judicial sector, but the revelation in late 2000 of a broad and deep corruption ring organized by former presidential advisor Vladimiro Montesinos heightened awareness of the problem. Transparency International ranked Peru number 70 (out of 163 countries) in its 2006 Corruption Perception Index. While anti-corruption efforts have been a stated priority of both the Toledo and Garcia Governments, in practice most resources are directed at investigating Fujimori-era corruption. In 2001, President Toledo appointed an anti-corruption "czar" to lead government efforts, but this official resigned in 2002 and has yet to be replaced. Private sector groups have increased efforts to combat corruption through an NGO called "ProEtica," which represents Transparency International in Peru.

Bilateral Investment Agreements

Peru has signed bilateral investment agreements with 29 countries (listed below), but not with the United States. The U.S.-Peru Trade Promotion Agreement (PTPA), pending approval by the U.S. Congress, would eliminate the need for a bilateral investment agreement. Peru's Current Bilateral Investment Agreements:

Argentina (1994)
Australia (1995)
Bolivia (1993)
Chile (2000)
China (1994)
Colombia (1994)
Cuba (2000)
Czech Republic (1994)

Denmark (1994)
Ecuador (1999)
El Salvador (1997)
Finland (1995)
France (1993)
Germany (1995)
Italy (1994)
Korea (1993)
Malaysia (1995)
The Netherlands (1994)
Norway (1995)
Paraguay (1994)
Portugal (1994)
Romania (1994)
Singapore (2003)
Spain (1994)
Sweden (1994)
Switzerland (1991)
Thailand (1991)
United Kingdom (1993)
Venezuela (1996)

OPIC and Other Investment Insurance Programs

The Overseas Private Investment Corporation (OPIC), an independent U.S. Government agency, offers medium- to long-term financing and political risk insurance. OPIC signed agreements with Peru in December 1992, and in July 1994, OPIC began approving requests for political risk insurance (including for inconvertibility of currency). In 2001, OPIC provided project finance loans of USD 108.4 million. In 2005, OPIC provided USD 800 million worth of insurance coverage for a copper mine and a startup finance company received USD 27 million worth of OPIC insurance coverage. Because of the free convertibility of currency, the U.S. Embassy purchases Peruvian currency for expenses on an as-needed basis, at the market exchange rate. The risk of significant depreciation of the exchange rate over the next year is negligible. Peru is a member of the Multilateral Investment Guarantee Agency.

Labor

Labor is abundant and trainable, although there are shortages of highly skilled workers in some fields and wages for professional staff are high (sometimes higher than U.S. wages in the mining sector for positions in the managerial and consulting fields). The presence of organized labor in the Peruvian economy has declined; in 2005, 8.6 percent of the labor force was organized. Unemployment in Lima officially stood at 7.2 percent in October 2006, compared with 7.9 percent a year earlier. Surveys show that 53.5 percent of Lima's economically active population was underemployed in the third quarter of 2006, mostly working in the informal sector for below subsistence wages. The statutory monthly minimum wage was raised in January 2006 to 500 soles (about USD 155). Some workers, like miners, are highly paid and also (per statute) receive a share of company profits.

In 1991-1992, a new labor law and other related statutes replaced extremely inflexible old statutes and regulations. The new laws allow for multiple forms of unions across company or occupational lines, thus permitting multiple unions in the same company. Workers in probation status or on short-term contracts are not eligible for union membership. Bargaining agreements are considered contractual agreements, valid only for the life of the contract. Productivity provisions must be included in any collective bargaining agreement. The number of officials and the amount of time union officials may devote to union work with pay is limited to 30 days per year. Unless there is a pre-existing labor contract covering an occupation or industry as a whole, unions must negotiate with each company individually. A labor law passed in July 1995 liberalized hiring. Business leaders lauded the above

changes, saying they led to greater efficiency. Labor leaders disagreed, arguing that the new labor laws eroded labor protections and encouraged outsourcing in a way that undercut union activity.

With Peru's return to democracy in 2000, Peruvian organized labor regained some, but by no means all, of the protections enjoyed in the pre-Fujimori era. A decision by the Constitutional Tribunal in 2004, for example, legitimized collective industry-wide bargaining in the civil construction industry. Labor leaders saw this as a potential precedent to be applied to other activities, but that has not yet happened. Furthermore, new laws added to labor inflexibility because the restrictions for termination and downsizing have made businesses reluctant to hire new employees and have created incentives to outsource.

Either unions or management can request binding arbitration in contract negotiations. Strikes can be called only after approval by a majority of all workers (union and non-union) voting by secret ballot and only in defense of labor rights. Unions in essential public services, as determined by the government, must provide a sufficient number of workers during a strike to maintain operations.

The 1993 Constitution provides for a maximum workday of eight hours, with 48 hours as the maximum week. The labor code also sets 24 hours rest per week and 30 days paid annual vacation for all workers. Workers readily sacrifice these and other benefits in exchange for regular employment. Strike activity declined markedly over the ensuing nine years and since new labor laws were passed, worker efficiency rose substantially. However, strikes and militant industrial action increased again in late 2002 and early 2003, with additional strikes in 2004. The overall number of strikes fell in 2005. Through October 2005, there were 58 strikes with a loss of 442,586 man-hours, compared with 91 strikes and a loss of 515,480 man-hours in the same period of 2004.

Congress continues to debate a comprehensive labor law reform, which may result in a return to inflexibility of the conditions of dismissal for employees.

Foreign Trade Zones/Free Ports

Peruvian law currently covers two types of free trade zones: export, transformation, industry, trade and services zones (CETICOS), and a free trade zone (ZOFRATACNA) in Tacna. The rules and tax benefits applying to these zones are the same for foreign and national investors.

Companies established at the CETICOS and ZOFRATACNA, which export no less than 92 percent of their output (more than 80 percent of production for the Loreto CETICOS and more than 50 percent for ZOFRATACNA), are exempted until 2012 from all taxes, dues and contributions to the central government and municipalities, particularly income, sales (IGV), Municipal Promotion (IPM) and excise (ISC) taxes. CETICOS exist at Ilo, Matarani and Paita, with one authorized but not operating at Loreto. There is a concern that the Peruvian Government does not have the proper WTO waivers to validate the CETICOS export requirement. The U.S. automotive industry has expressed a specific concern that U.S. brands are unable to compete with used Japanese vehicles that enter the Peruvian market duty-free through the CETICOS. Importers located in ZOFRATACNA pay only 8 percent customs duties (normal rates are 12 or 20 percent) on 1,086 items sold to retailers in the city of Tacna.

Foreign Direct Investment Statistics

The stock of registered foreign direct investment in Peru was USD 14.3 billion in December 2006, according to

ProInversion, versus USD 13.9 billion at the end of 2005. ProInversion data place Spanish investors as holding the largest share (33 percent), with USD 4.7 billion invested. The United States is the second largest investor, with USD 2.3 billion, and the United Kingdom is third, with USD 2.2 billion. However, according to the U.S. Department of Commerce, U.S. registered investment in Peru through December 2006 totaled USD 3.9 billion on a replacement-cost basis. The statistics are skewed because ProInversion records investments on the basis of country registry, rather than control. Thus, an investor registered in the Bahamas, for example, is recorded as British even if the parent is a U.S. company. As a result, U.S.-controlled investment represents a much higher share than the official 15.8 percent. By sector, communications received 34.7 percent of foreign direct investment in 2006, followed by the manufacturing industry (15.3 percent), mining (14.8 percent), and finance (12.5 percent).

As of the end of 2006, investors had signed 640 legal stability contracts with the Government of Peru through ProInversion. Legal stability contracts commit the government not to apply any future changes in the income tax, labor and other laws governing a specific investment in exchange for commitments to invest a given amount. In addition to these contracts, the Government of Peru has signed numerous tax, foreign exchange and administrative stability contracts through several ministries, mainly the Ministry of Energy and Mines.
POWERS